

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Rev. & Tax. Committee Analyst: Marion Mann DeJong Bill Number: SB 2171

Related Bills: _____ Telephone: 845-6979 Amended Date: 05/08/2000

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Insurance Dividend Deduction/Remove Commercial Domicile/Repeal of Water's-Edge NOL Limitation/Taxpayer Notices

SUMMARY OF BILL

This bill would do the following:

1. For corporations that are commercially domiciled outside of California, remove the prohibition on deducting dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax. All corporations would be permitted to deduct dividends regardless of where commercially domiciled. See the department's analysis of the bill as introduced.
2. Correct an error inadvertently created by SB 1229 (Stats. 1999, Ch. 987), and carry out the intent of SB 1229 by providing relief from the annual limited partnership tax for specified limited partnerships. See "Limited Partnerships" on page 2.
3. Eliminate the water's-edge net operating loss (NOL) limitation provision. See "Repeal of Water's-Edge NOL Limitation" on page 4.

SUMMARY OF AMENDMENT

The April 10, 2000, amendments added the last two provisions discussed above and added a provision establishing a statute of limitations for collection actions.

The May 8, 2000, amendments removed the provision regarding the statute of limitation for collection actions.

The department's analysis of the bill as introduced February 25, 2000, still applies. The two new provisions are discussed separately below.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. The operative dates of the specific provisions are discussed in the analysis of each provision.

SUMMARY OF FISCAL IMPACT

The April 10, 2000, and May 8, 2000, amendments would increase estimated revenue losses by an additional \$1 million annually. Revenue losses for the bill as introduced February 25, 2000, could not be quantified.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Alan Hunter for GHG

5/12/00

The amendments added two provisions, one that impacts revenue. The provision eliminating the present law water's-edge net operating loss limitation would increase revenue losses by an additional \$1 million annually beginning in 2000-01.

Estimated Revenue Impact of SB 2171 As Amended 4/10/00 and 5/8/00 [\$ In Millions]			
Provision	2000-01	2001-02	2002-03
Remove commercial limitation	unknown losses	unknown losses	unknown losses
Granting relief to all LPs (current law clarification)	no impact	no impact	no impact
Eliminate water's-edge NOL limitation	-\$1	-\$1	-\$1

BOARD POSITION

Pending.

The Franchise Tax Board voted at its January 12, 1998, meeting to sponsor the language to remove the commercial domicile prohibition. The Franchise Tax Board voted at its December 16, 1998, meeting to sponsor language to provide relief from the annual limited partnership tax for incompletely cancelled limited partnerships. The Franchise Tax Board voted at its December 16, 1999, meeting to sponsor the language to remove the water's-edge NOL limitation.

2. Limited Partnerships

EFFECTIVE DATE

The bill specifies that this provision is consistent with the amendments made by SB 1229 (Stats. 1999, Ch. 987) and is declaratory of existing law. Thus, this provision of the bill would apply retroactively to taxable years beginning on or after January 1, 1997, as did SB 1229.

BACKGROUND

In 1993 the limited partnership (LP) tax was extended to all LPs organized in this state or registered with the Secretary of State (SOS) to transact business in this state. The tax was required to be paid for each taxable year until a certificate of dissolution or cancellation was filed with the SOS.

The portion of the statutory language allowing the obligation to pay the tax to be extinguished by filing a certificate of dissolution was enacted in error. It was erroneous because under the Corporations Code the existence of a corporation is extinguished by dissolution; the existence of an LP is extinguished by cancellation. Consequently, filing a certificate of dissolution is not the correct method to extinguish the existence of an LP.

This error was corrected in 1997 with the enactment of SB 1106 (Stats. 1997, Ch. 604). Effective for taxable years beginning on or after January 1, 1997, a certificate of cancellation was the only filing that would extinguish liability for the LP tax. However, this legislation did not provide transitional relief for an LP that had stopped doing business, filed a final tax return, and filed a certificate of dissolution, but failed to file a certificate of cancellation with the SOS.

SB 1229 (Stats. 1999, Ch. 987) provided relief from the tax for LPs that ceased doing business prior to January 1, 1997, that filed a final tax return with FTB, and that filed a certificate of dissolution with the SOS.

However, as drafted, SB 1229 erroneously limited the relief to LPs that file a certificate of cancellation with the SOS on or after October 10, 1999. A substantial number of LPs filed certificates of cancellation with the SOS prior to October 10, 1999. As the law is presently written, these entities are excluded from relief under SB 1229. This was not the intent of SB 1229.

SPECIFIC FINDINGS

Current law requires every LP doing business in California, organized under the laws of California, or registered with the SOS to transact intrastate business in California to pay an annual tax. The amount of the tax is equal to the minimum franchise tax (currently \$800). The tax is required to be paid for each taxable year, or part thereof, until a certificate of cancellation is filed with the SOS.

This provision of the bill would provide that certain LPs would not be subject to the annual tax for any period following the date the certificate of dissolution was filed with the SOS, but only if the LP files a certificate of cancellation with the SOS. The relief would be provided for LPs that ceased doing business prior to January 1, 1997, filed a final tax return with FTB for a taxable year ending before January 1, 1997, and filed a certificate of dissolution with the SOS prior to January 1, 1997. However, the relief would be provided only if the LP files a certificate of cancellation with the SOS. In the case where a notice of proposed deficiency assessment (NPA) or a notice of tax due (NTD) is mailed to an LP after January 1, 2001, the LP has 60 days after the mailing date of the NPA or NTD to file a certificate of cancellation with the SOS to be eligible for relief.

Policy Considerations

This bill would correct an inadvertent error created by SB 1229 and would carry out the intent of SB 1229. Nothing in the legislative history of SB 1229 indicates that it was the intent that relief should be denied if the LP filed the certificate of cancellation with the SOS prior to the date of enactment of SB 1229 (October 10, 1999).

Implementation Considerations

Implementing this provision would provide relief for approximately 150 taxpayers that meet the intent but not the literal language of the current statute.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue associated with granting relief to all LPs was included in the revenue estimate for SB 1229. This provision of the bill is consistent with the intent of SB 1229 and is considered declaratory of existing law. Thus, this provision of the bill would not impact PIT revenues.

3. Repeal of Water's-Edge NOL Limitation

EFFECTIVE DATE

This provision would apply to income years beginning on or after January 1, 2000.

SPECIFIC FINDINGS

Generally, a net operating loss (NOL) results when a taxpayer's business expenses exceed income in a particular year. The resulting "operating loss" for that year may be carried forward or back (federal only) as a "net operating loss."

For **federal** purposes, an NOL can be carried back to each of the two preceding years and carried forward to each of the 20 following years.

Federal law treats an NOL as a tax attribute of the taxpayer. Thus, if a corporation with NOLs ("loss corporation") ceases to exist as a result of a reorganization or liquidation described in Internal Revenue Code (IRC) Section 381, the successor corporation will stand in the shoes of the loss corporation with respect to claiming deductions of the NOLs.

If there has been an ownership change in which the percentage of a loss corporation's stock owned by 5% shareholders increases by more than 50 percentage points, then a ceiling is placed on the amount of the loss corporation's NOLs that can be deducted in any one year. The ceiling is the value of the loss corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate¹. The purpose of the ceiling is to prevent buying and selling of loss corporations by profitable businesses for the sole purpose of acquiring unused NOL carryovers.

When a consolidated return is filed for federal purposes, NOLs are generally computed and carried back or forward on a consolidated group basis. Exceptions occur when corporations enter or leave the consolidated group. If an entering member has an NOL carryover from a pre-consolidation year (this is termed a "separate return limitation year," or SRLY), that NOL may be deducted against only the portion of the consolidated taxable income that is attributable to that corporation.

¹ The long-term tax-exempt rate means the highest of the adjusted federal long-term rates in effect for any month in the three-calendar month period ending with the calendar month in which the ownership occurs.

If a corporation that generated a consolidated NOL carryover leaves the consolidated group, it takes with it an allocated portion of the group's unused NOL carryover.

State law generally conforms to the federal NOL provisions with three major exceptions: (1) California law does not permit carry-back of the NOL deduction, (2) carryover is generally limited to five years, and (3) generally only 50% of the NOL can be carried forward.

State law contains special NOL provisions for taxpayers that operate "new businesses" or "eligible small businesses;" suffer disaster losses; and that operate businesses within an enterprise zone, a local agency military base recovery area (LAMBRA), or a targeted tax area (TTA). Specific details of these special provisions are not provided since they are not relevant to the problem discussed in this proposal.

The following table recaps the various California NOL provisions:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	50%	5 Years
New Business Year 1	100%	8 Years
Year 2	100%	7 Years
Year 3	100%	6 Years
Eligible Small Business	100%	5 Years
Specified Disaster Loss	100%	5 Years
	50%	10 Years
LAMBRA, TTA & EZ	100%	15 Years

In the case of corporations doing business both within and without this state, California, as do most states, taxes corporations exclusively on a source basis. The amount of California source income is determined by use of an apportionment formula. While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs (Section 25108) provides that a taxpayer has a California NOL based on the sum (or net) of its California-apportioned income (or loss) and its allocated income (or loss).

NOLs - Combined Report & Water's-Edge

California does not conform to the federal consolidated return rules. Instead, California source income for corporations that operate both within and without the state is determined using unitary principles and combined reporting. Under the worldwide combined reporting method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California and to the taxpayer members on the basis of relative levels of business activity in the state as measured by property, payroll, and sales.

As an alternative to the worldwide combined report, **California law** allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally may exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

A fundamental difference between a California combined report (either worldwide or water's-edge) and a federal consolidated return is the concept of a group versus separate entities. The federal consolidated return generally treats the group as a single taxpayer. The members of a California combined report are treated as a unit for purposes of combination and apportionment, but their separate entity status is preserved for all other purposes.

Unlike federal consolidated NOLs that are generally computed on a group basis, NOLS of members of a California combined report are separately computed. Each taxpayer member of a California combined report is attributed a share of the unitary group's California-source business income or loss (this is known as intrastate apportionment), which it aggregates with its own California-source nonbusiness income or loss. If the result is a net operating loss, that taxpayer will carry the NOL forward to be deducted against its California-source income in subsequent years. Because each member of a combined reporting group tracks and applies its own NOL, there is generally no need for special rules to account for members entering or leaving the combined reporting group.

California law imposes an NOL limitation for any year in which a water's-edge election is in effect (water's-edge NOL limitation). If a water's-edge taxpayer has an NOL carryover from a pre-water's-edge year, it must re-compute its carryover as if it had a water's-edge election in effect in the loss year. If the recomputed NOL carryover is less than the actual NOL carryover, the taxpayer's NOL deduction is limited to the recomputed amount.

For example, assume the following facts for a taxpayer that makes the water's-edge election for 1998:

	1996	1997	Carryover to 1998
Worldwide income/NOL (stated at 50%)	(\$300,000)	\$200,000	(\$100,000)
Water's-edge income/NOL (stated at 50%)	(\$150,000)	(\$50,000)	(\$200,000)
Lesser of worldwide NOL or water's-edge NOL (the re-computed NOL).	(\$150,000)		
Because 1997 is not a loss year on a worldwide basis, no re-computation is made.		\$200,000	
The re-computed 1996 NOL does not exceed the actual 1997 income, so there is no remaining carryover to 1998.			\$0

In the above example, the taxpayer had an actual NOL carryover to 1998 from worldwide years and would have had an even greater NOL carryover to 1998 if it had filed water's-edge in the previous years. However, because only the loss year is recomputed (1996 in the above example), no NOL carryover is available for deduction in 1998.

There are inconsistencies in the way that the water's-edge NOL limitation operates. The NOL carryover that can be deducted for a year with a water's-edge election is limited to the amount that would have been available if the taxpayer had filed on a water's-edge basis in the loss year. This operates only as a limitation; the NOL carryover cannot be increased if the taxpayer would have had larger NOLs on a water's-edge basis.

There is no comparable limitation for water's-edge taxpayers with NOL carryovers that end their election and go back to a worldwide combined report. Furthermore, only the loss years are recomputed, so a fictional recomputed water's-edge NOL from a loss year could be used against worldwide income in an intervening year before becoming available to be deducted in a year with a water's-edge election as in the example above.

The water's-edge NOL limitation is also inconsistent with unitary theory and with the way that NOLs generally interact with combined reporting. Once an NOL is generated, normal unitary rules ascribe that NOL to a specific taxpayer member. The NOL can be applied against any positive California source income, even nonbusiness income or income from a separate and distinct trade or business. If a taxpayer member with an NOL carryover is sold, that member takes its NOL carryover with it and applies the NOL to its share of California source income in subsequent years. Moreover, a water's-edge election is similar to a break up of a unitary group. However, termination of a unitary relationship does not result in the re-computation of losses that arose during the unitary relationship that is required by the water's-edge NOL limitation.

This provision of the bill would remove the water's-edge NOL limitation.

Policy Considerations

The water's-edge NOL limitation can be a burdensome requirement for taxpayers since they are required to re-compute prior loss years on a water's-edge basis for no reason other than to determine the NOL limitation. These are often complex computations that require information that may not be readily available. This provision of the bill would eliminate the NOL limitation. There does not appear to be any strong theoretical justification for the limitation, and the limitation is not necessary to prevent any identified opportunity for abuse. Thus, the water's-edge NOL limitation does not appear to justify its complexity or the inconsistencies in the way the water's-edge limitation operates.

Implementation Considerations

Implementing this provision of the bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the department's normal annual update.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The current law water's-edge NOL limitation is very complex with few taxpayers correctly applying recalculations for years not filed on a water's-edge basis. Consequently, the revenue loss from this proposal would be predominantly attributed to audit assessments. It is projected that the revenue loss would be on the order of \$500,000 to \$1 million annually beginning in 2000-2001.